



COMMONWEALTH OF THE BAHAMAS

2009/2010 MID-YEAR BUDGET STATEMENT

ON THE SIX MONTHS ENDING 31st DECEMBER 2009

Presented to the Honourable House of Assembly

by

**The Rt. Hon. Hubert A. Ingraham, M.P.
Minister of Finance
on
Wednesday, 24th February, 2010**

INTRODUCTION

I have the honour to present the Mid-Year Budget Statement for the six-month period ending December 31, 2009.

In the 2009/10 Budget Communication, presented at a time of exceptional uncertainty arising from the global economic and financial crisis, I laid out the three core pillars of my Government's medium-term course of action aimed at benefiting the Bahamian people and our nation as a whole.

Our medium-term strategy in this global crisis consisted of:

1. Maintaining fiscal flexibility in order to be able to deal with any worsening of economic conditions and, to the extent possible, maintaining employment and living standards;
2. Implementing projects to both create employment and build the infrastructure our country will need to prosper as the economic upturn takes hold; and
3. Reducing the debt-to-GDP ratio as economic conditions permitted in order to recreate the fiscal headroom used during the crisis and thereby positioning us to be able to deal with any future crisis.

In the 2009/10 Budget, I also stressed the vital importance of maximizing existing revenues by modernizing all aspects of revenue administration as well as enhancing the efficiency of all aspects of current expenditure. Actions on these fronts are critical to restoring our public finances to a solid and sustainable basis.

In light of developments since the Budget Communication, this prudent and provident policy stance has served The Bahamas well. In this Mid-Year Statement, I wish to report on the concrete actions and initiatives that my Government has taken in respect of these policy pillars.

This Mid-Year Statement also fulfills, for the third straight year since our return to office, my Government's unwavering commitment to transparency and accountability in budgeting. Accordingly, the Statement sets out:

- the economic background of the fiscal year to date;
- the fiscal performance during the first six months of the fiscal year; and
- proposed revisions, reductions or additions to expenditure for the approval of Parliament.

This Mid-Year Statement serves an important role in promoting good governance. Through it, the Government reports to Parliament on the progress that it is making at the mid-point of the fiscal year in achieving the goals and objectives that it presented in the Budget Communication. It is also the vehicle through which Ministers report to Parliament and to Bahamians on the achievements in their portfolios and request any additional resources required to meet the needs of their portfolio responsibilities. Additionally, the Statement provides details on reductions necessary due to changes in priorities and circumstances. By this process, the House therefore has access to the information required to examine the use and management of public funds.

MODERNIZATION OF GOVERNMENT

Strengthening Financial Administration and Audit

In the 2009/10 Budget Communication, I tabled a Discussion Paper on strengthening accountability and transparency in public financial administration to serve as the basis for an extensive process of consultations with Members of Parliament, senior officials and the public. With the completion of the consultation process, a new and modern Financial Administration and Audit Act is being finalized and will soon be tabled in Parliament. It is our intention that the new Act would take effect with the start of the next fiscal year.

Modernizing Revenue Administration

Recognizing the need to modernize how we administer government revenue, we invited the Caribbean Regional Technical Assistance Centre (CARTAC), with the assistance of the Fiscal Affairs Division of the IMF, to undertake an in-depth review of our revenue administration through a diagnostic mission in September 2009. The purpose was to develop a detailed assessment of current revenue administration and to provide guidance and recommendations on options for reform.

We have now begun implementation of the core recommendations of that mission. With the technical assistance of CARTAC, we will begin developing a Central Revenue Administration based on international best practice. When fully implemented, the new Tax Administration will feature an efficient function-based structure and it will be responsible for administering a broad range of existing taxes. It will also benefit from modernized arrears management and compliance strategies. A new Planning and Monitoring Unit within the Administration will be responsible for strategic and operational planning, as well as performance monitoring and improvement.

Reform of Customs

We are now well on our way in bringing about fundamental reform and modernization of Customs operations, including enhanced utilization of information technology. Two international Customs experts have been engaged to assist in guiding and supporting this process.

Some of the key reforms will bring Customs operations and procedures up to international best practice standards. These reforms include strengthened risk management, post-clearance audit, development and use of performance indicators and improved information for and collaboration with the business community.

A new shift system was introduced at Customs and Immigration in January that will reduce overtime costs and enhance service to clients.

Strengthening Management for Results in the Public Service

In order to further strengthen public expenditure management, the Government has worked with the Inter-American Development Bank (IDB) to develop a Plan of Action to introduce Results Based Management (RBM) in the Public Sector of The Bahamas.

In a nutshell, the Plan of Action comprises the following initiatives:

- Introduction of a multi-year strategic plan that defines the Government's strategic objectives inclusive of indicators for measuring the performance of, and enhancing the quality of, public expenditure;
- Introduction of budgeting for results by linking strategic planning to the execution of the budget;
- Designing and implementing an electronic information system to incorporate financial information provided by Family Island-Local Governments into the electronic financial management system;
- Strengthening the institutional capacity of Ministries and Departments to introduce and utilize Management for Results principles;
- Modernizing the institutional framework for monitoring and evaluating performance of public investment projects;
- Upgrading the legal framework for government procurement, with transparent guidelines for the procurement and contracting process;
- Improving the information technology and equipment needed to design and install an electronic procurement system; and
- Improving the timeliness and efficiency of the Auditor General's operations.

We are now moving forward with the IDB in the implementation of this action plan.

Modernizing Public Procurement Practices

Finally, we have launched another initiative with the IDB to improve the public procurement process in The Bahamas. Regulations complementary to the Financial Administration and Audit Act will be strengthened to more clearly define procedures and provide guidance and direction for objective decision-making in the procurement process. Through this initiative, we are striving to standardize and modernize procedures such that they will be consistent with best international practices bringing about greater fairness, accountability, efficiency, economy and transparency in how the government secures goods and services.

Securing the Financial and Operational Sustainability

of the Water and Sewerage Corporation

The Water and Sewerage Corporation continues to be a challenge for the Government from both a financial and an operational perspective. The Corporation has increased its reliance on more expensive desalinated water; tariffs have remained unchanged since 1999; there have been inadequate capital expenditures as subsidies have been diverted to cover increasing operating losses; and non-revenue water has risen to 55% of production.

The Government allocated \$19 million to WSC for the 2009/10 fiscal year. The Corporation is now seeking an additional \$8.9 million. It is proposed that an additional \$6.8 million be provided as the maximum amount that the public purse can afford at this time.

Clearly without a break in this cycle, this need for ongoing, perhaps rising Government subsidies will go on ad infinitum. That is not a sustainable situation.

With the assistance of the Inter-American Development Bank, a detailed Water and Sanitation Sector Plan has been developed to reverse the Corporation's dismal operational and financial situation and transform it into a financially sustainable company. The Corporation has been directed to implement that plan.

IMPROVING THE BUSINESS ENVIRONMENT

Streamlining the Business License Act

We are taking a number of steps to strengthen the Bahamian business environment. Specifically, proposed amendments to the Business Licence Act will soon be introduced to simplify the legal and regulatory requirements to operate a business. The amendments will eliminate the need for separate applications for shop, liquor, music and dancing and other occasional licences. We also propose to simplify the fee structure for Business Licence.

Streamlining the Regulation of Financial Services

The Government is also moving to streamline the regulation of non-bank financial services. Specifically, we intend to merge the Securities Commission, the Office of the Registrar of Insurance Companies and the Compliance Commission to create a new Financial Services Authority. The goal is to reduce burdens on the regulated financial sector by simplifying authorization requirements and data reporting requirements. As well, efficiency gains will be achieved by ensuring joint operations in terms of on-site inspections, authorizations, information technology and human resources.

A detailed plan of implementation is being developed with a view to having the new Authority operational this year. Already, the physical consolidation of these agencies has been achieved at Charlotte House and is advancing their ability to cooperate on some administrative and regulatory levels.

Enhancing the Competitiveness of Financial Services

On April 2, 2009 following the G20 Summit in London the OECD published a list (the so-called Gray list) of 38 countries assessed by the Global Forum as non-cooperative jurisdictions in relation to international standards for the exchange of tax information. The Bahamas was on that list.

The G20, noting the publication of the list by the OECD, agreed to take action against the non-cooperative jurisdictions which have until 31st March to exit the list upon the execution of at least 12 tax information exchange agreements.

On April 2, 2009, The Bahamas had one agreement executed with the U.S. We have moved aggressively to meet the requirement. At present, there are 11 signed agreements and, by the end of March, we will have executed 19 agreements to ensure our exit from the Gray list.

In addition, the Investment Funds Act will be amended to remove restrictions that impact negatively on Bahamian investment managers and advisors and the competitiveness of The Bahamas as a financial centre.

THE ECONOMIC CONTEXT

The Global Economic Outlook

Before reviewing fiscal performance in the first six months of the current fiscal year, I shall present a brief overview of the global economic environment, followed by a review of recent economic developments in The Bahamas and the near-term outlook.

Underpinned by extraordinary support on the fiscal, monetary and financial fronts by governments worldwide, the global economy pulled out of its deepest slump in recent history and bounced back in the second half of 2009. It is recovering

faster than had been expected previously and, according to the IMF's January World Economic Outlook, world growth is now projected at near 4 per cent in 2010 and 4.3 per cent in 2011.

Developments in the U.S. have also been more encouraging than we anticipated at the time of the 2009/10 Budget Communication. After four straight quarters of decline, the economy of our major trading partner registered two quarters of positive growth at the end of 2009. In the fourth quarter, real GDP grew at a robust 5.7 per cent annual rate, its strongest pace since 2003. This was positive news indeed and contrasts sharply with the fact that in 2009 the U.S. economy registered its largest annual decline since 1946. Its contraction, at 2.4 per cent, was also the first in almost 20 years.

Recovery in the U.S is, however, expected to be more sluggish than in previous times as persistent high unemployment rates, weak household balance sheets and fiscal policy challenges will all impinge on the speed and strength of the rebound. In its latest projection, the IMF expects the U.S. economy to expand by 2.7 per cent and 2.4 per cent this year and next, respectively.

A modest pace of recovery is also expected in the advanced economies as a whole. The economy of the Euro area, for example, is expected to grow by 1 per cent in 2010 and 1.6 per cent in 2011. For Japan, growth rates of 1.7 per cent and 2.2 per cent are anticipated. In contrast, the economies of China and India are expected to continue to expand strongly, by roughly 10 per cent and 8 per cent, respectively.

Domestic Economic Developments

During 2009, the Bahamian economy faced significant challenges, as the adverse effects of the global financial and economic crisis continued to impact real sector developments.

As a consequence of the fall-out in overseas demand, tourism output weakened sharply, although key industry trends suggest some stabilizing in output.

Economic indicators suggest persistent weaknesses in construction output during 2009, as evidenced by the slackened levels of both residential and foreign investment-led commercial activities.

Reflective of the pass-through effects of the broad-based decline in international commodity prices from their record highs in mid-2008, inflation in 2009 slowed by 2.4 percentage points to 2.1%, following a 2.0 percentage point advance to 4.5% in 2008.

As a result of large-scale layoffs in the hotel sector, unemployment rose to an estimated 14.2% in 2009, up 5.5 percentage points from 2008.

The growth in Bahamian dollar credit declined sharply by \$310.8 million to \$158.0 million in 2009, largely reflecting reduced private sector credit growth. Consumer credit, which accounts for roughly 35% of private credit, decreased by \$42.2 million, reversing the \$113.2 million expansion in 2008. Mortgage growth abated by \$90.8 million to \$120.3 million.

Despite a significant 81.6% reduction in the net foreign exchange purchase from the banking sector due to the anemic performance of the foreign exchange earning sectors, external reserves expanded by \$256.0 million. At end-December, external reserves stood at \$818.4 million, equivalent to a projected 19.5 weeks of non-oil imports—up from 13.1 weeks at end-2008.

With the weakened economic situation, banks' credit quality indicators deteriorated considerably in 2009. Total private sector arrears increased by \$324.3 million (42.4%) to \$1.1 billion, representing 17.6% of total loans—a gain of 5.2 percentage points.

In response to these developments, banks increased their provisioning for doubtful accounts by \$44.4 million to \$213.6 million, and adopted more conservative lending practices.

Although global and U.S. economic indicators have shown some improvement in recent months, the tentative pace of the recovery, combined with an observed shift in U.S. consumption patterns towards increased savings, will continue to constrain the return to positive growth momentum for the Bahamian economy in the short-term. Having experienced a decline in excess of 4 per cent in 2009, the domestic economy is now anticipated to record a further contraction in 2010, though at a more modest rate of a little more than 1 per cent. This represents weaker performance than had been

expected at the time of the 2009/10 Budget Communication, when declines of 3.5 per cent and 0.5 per cent were projected. The economy is projected to strengthen as we move through 2010 and positive growth on an annual basis is expected to return in 2011 and beyond.

A regular IMF Article IV Consultation, planned for early May of this year, will present an objective and expert assessment of the Bahamian economy and outlook. As is our usual practice, the Report from the Consultation will be presented to Parliament as soon as it is finalized.

2009/10 BUDGET PERFORMANCE

In the 2009-10 Budget Communication, my Government projected a GFS Deficit of 3.9% of Gross Domestic Product for this fiscal year.

Public finances in the first six months of the 2009/10 fiscal year were adversely affected by the economic developments that I have just reviewed. Recurrent revenues in particular were weaker than we had anticipated at the time of the last Budget Communication, though they were nonetheless bolstered by one-off receipts of \$84 million. We now expect that the deficit for 2009/10 will exceed the forecast of 3.9 per cent of GDP. As a result, public debt will rise to a level above the projection of 43.2 per cent of GDP presented in the 2009/10 Budget Communication. At the end of December 2009, public debt stood at 46 per cent of GDP.

As Honourable Members will know, Standard and Poor's lowered the sovereign credit ratings on The Bahamas in December because of the increased levels of deficit spending and government indebtedness stemming from the short-term measures introduced to support the economy.

In our response to that announcement, we reiterated the position set out in the 2009/10 Budget Communication to the effect that the necessary extraordinary fiscal measures introduced to support the economy and workers would only be short term in nature. We also reaffirmed our commitment, as soon as is practical, to return to a fiscal posture that will reverse this trend.

Indeed, in our three terms in office, my Government has maintained a steadfast vigilance over public finances in order to maintain our relatively favourable debt position. Accordingly, while we will maintain the short-term stimulus that we are providing to the economy and Bahamian workers, as global and domestic conditions recover we will frame fiscal policies so as to arrest the rise in the public debt burden and reverse its course back to more acceptable and prudent levels. That will require that we maintain strong discipline over recurrent expenditure as well as having an ongoing determination to properly collect all revenues rightfully due to Government. Further details will be presented at the time of the 2010/11 Budget Communication.

In this Statement, we are making adjustments to Recurrent and Capital Expenditures but, importantly, we are committed to remain within the total expenditure limits already approved by Parliament for expenditure in fiscal 2009/10, at the time of the Budget and in the November Supplementary Appropriations.

The Mid-Year Progress Report being circulated with this Mid-Year Budget Statement shows the progress for the first 6 months of the 2009/10 fiscal year, that is for the period July to December 2009 of Recurrent and Capital Expenditure and Recurrent Revenue. The purpose of the data is to enable this Honourable House to assess the progress made through the 2009/10 Budget across the whole range of Government spending and revenue.

The totals for expenditure and revenue for the first six-month period of the fiscal year must be viewed with caution as there are seasonal and other timing factors in play which will only be eliminated when accounts are closed at the end of the fiscal year. Accordingly, allowance must be made for these types of factors in analyzing the data.

Recurrent Expenditure

The data for the first six months of the 2009/10 Fiscal Year reveal that actual Recurrent Expenditure totaled \$742.8 million, up \$9.8 million from the forecast. That total excluded the refinancing of a short-term borrowing of \$200 million that had been effected in May 2009, through the proceeds of the Government's longer term \$300 million bond issue in November of last year.

The Supplementary Recurrent Expenditure provided for in this Mid-Year Budget Statement amounts to \$35.6 million.

Recurrent Revenue

In line with the weaker economic activity in 2009 than had been expected at the time of the last Budget Communication, recurrent revenues in the first six months of the 2009/10 fiscal year were lower than expected. Total revenue collections for the July to December 2009 period amounted to \$634.9 million, up \$8 million over the corresponding period of 2008/09. However, that total included one-off revenue collections totaling \$84 million, including those relating to the sale of South Riding Point Holdings, that had not been included in the Budget forecast. Collections excluding those one-off items were thus \$76 million lower than the corresponding period last year. This also represents 40% of the revenue forecast for the full year, somewhat lower than the typical proportion of revenue that is collected in the first half of the year.

Relative to the performance during the first six months of 2008/09, the principal revenue shortfalls occurred in respect of Import and Export Duties, at \$21.9 million, Stamp Tax, at \$21.7 million, and Excise Tax at \$13.1 million. Notable gains year-over-year were recorded in Real Property Tax, at \$6.2 million.

Capital Expenditure

In the first six months of the 2009/10 fiscal year, Capital Expenditure amounted to \$140.1 million, or 55 per cent of the estimate for the entire fiscal year presented in the 2009/10 Budget Communication.

The Supplementary Capital Expenditure provided for in this Statement amounts to \$48.6 million.

CONCLUSION

In conclusion, I want to reiterate the importance of this Mid-Year Statement as a vital instrument for enhancing transparency in governance.

Through this Statement and the accompanying Mid-Year Progress Report, I have provided a mid-course update on my Government's measured and judicious management of public finances. That stance, which we have maintained over time, has afforded us the much-needed fiscal flexibility and headroom that we required to provide short-term support to the economy and workers, all the while never losing sight of our fundamental fiscal anchors.

We are weathering the economic and financial storm as well if not better than might have been expected several months ago and a glimpse of clearing skies is gradually emerging on the horizon. We are committed to capitalizing on the better days ahead to rebuild the fiscal headroom that we have used since the global maelstrom hit our shores.

I draw the attention of Honourable Members to the Tables and Graphs on the economy and public finances included in the Statement.

I have the Honour to present the Mid-Year Budget Statement.